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## RISK-SHARING: THE SOLE BASIS OF ISLAMIC FINANCE? IT IS TIME FOR A SERIOUS RETHINK

Zubair Hasan\*

### Abstract:

*There has been a disquieting revival of an old precept in Islamic finance - 'no risk, no gain' - in the wake of the global financial crisis that started with the 2007 sub-prime debacle in the US. The recent proponents of the precept argue that the basic reason for the recurrence of such crises is the interest based conventional system of financing because it subsists **solely** on transference of risks to counter parties. In contrast, Islam shuns interest and promotes, they say, **only** the sharing of risks, not their transfer. The distinction is used to make a case for replacing the conventional system with the Islamic; for that alone is thought as the way to ensuring the establishment of a just and stable crisis free economic system. Empirics showing that Islamic banks have faced the current crisis better than the conventional are cited as the supporting evidence. The present paper refutes this line of argumentation and questions its basis and contentions.*

**Key words:** Financial crisis; Risk-sharing; Risk-transfer; Islamic banks; 'No risk, no gain' precept.

### 1. INTRODUCTION

Islam prohibits giving or taking of interest. It allows financing contracts broadly of two sorts. First is the financing on a participatory or profit and loss sharing basis. The contract may assume the form of *mudharabah* or *musharakah*. The Second is what are called the deferment contracts. Here the obligation of the party to make payment or of the party to deliver the effects is postponed to an agreed future date. The generic form of this arrangement is known as *murabaha* or the cost plus system. The plus part is known as the markup and derives its validity from an Islamic maxim that allows a time value for money in deferred price payments Laldin 2013, 30-36). This umbrella maxim covers both sorts of contracts we have mentioned. The choice of one or the other category is discretionary; no preference is indicated. Interestingly, the proponents of the risk-sharing precept accept this reality<sup>1</sup> without realizing that it conflict with the 'sole principle' tag they stick to risk-sharing; it becomes irrelevant, rather misleading. Instead, the proponents of the precept continue to parade their exclusivist approach without any let up. Their insistence on sharing of risk being the absolute and paradigmatic imperative of the Islamic financial system remains regrettably unrelenting.<sup>2</sup>

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\*The author is a Professor recently retired from INCEIF, Malaysia. He is grateful to Mohammed Ashraf Iqbal a PhD student who went through an earlier draft of the paper to help remove typos and suggested also a few improvements

<sup>1</sup> For example, see Chapra, (2014) and Osman and Mirakhor, (2014) for such acknowledgement.

<sup>2</sup> For deferment contracts are like interest-bearing debt contracts; sukuk are known as Islamic bonds. Indeed, the proponents of the principle themselves lament this being the position in Islamic finance. (See quotation from Mirakhor below in the text). Take note also of the very title of his forthcoming 2015 publication.

It is instructive to recall how all this confusion started. The early Islamic scholars eager to showing Islamic finance sans interest as superior to and distinct from the conventional saw the departure point in its participatory modes based on the sharing of profit and loss in financing and hastened to deduce that risk-sharing was an Islamic imperative for claiming any share in profit. The view led to the coinage of the precept - ***no risk, no gain*** (Chapra 1986, 64, 166).

The precept lay dormant in the literature, save some occasional mention until it was challenged in the literature (See for example Halim 1985 and Hasan 2005). However, the devastation that 2007-2008 financial turmoil inflicted on the global economy provided the proponents of Islamic finance with a fresh impetus to highlight the fallibility of the conventional system and push the divine one, as they understand it, to the fore as a replacement.

The reason for the turmoil was, they argued, the interest base conventional finance which subsists on transferring risks to counter parties. In contrast, Islamic finance, they believed, promotes risk-sharing that ensures stability and equity in the growth process. The distinction led to the retrieval of the ‘no risk, no gain’ precept from the literature. The task of reloading it back on the pedestal is led, rather religiously, by Prof Abbas Mirakhor the First Chair Holder of Islamic finance at the renowned INCEIF. *Risk-sharing* has mostly been a major theme in his recent lectures and writings on Islamic finance including the books he has co-authored with others (See references) and the PhD researches he supervises. He states his position as follows.

*Practitioners grounded in conventional finance, however, were interested in developing ways and means of finance that, while Shari’ah compliant were familiar to and accepted by market players in conventional finance. Scholars emphasized risk-sharing while practitioners focused on traditional methods of conventional finance based on risk transfer and risk shifting. In doing so, instruments of conventional finance were replicated, reverse engineered or retrofitted for Shari’ah compatibility, a somewhat regrettable process. (Mirakhor 2014, 107).*

The observations along with supportive statements on the topic in his other writings are put below as the basic convictions of Professor Mirakhor. The rendition is not unfair to him, I believe.

- The world’s financial system is inherently prone to instability and financial crises since it works ***solely*** through the transferring of risks, not through their sharing;<sup>3</sup>
- Islamic finance which allows ***only*** sharing of risks, not their transfer can ***alone*** pull the world back from the brink of disaster. It is *the* replacement for the faulty crisis-prone conventional system.

The contentions coming from a senior academician and practitioner carry far-reaching implications for Islamic finance, its substance, character and direction. That the interest-based conventional system of finance is fragile and unstable is an established fact. That equity is better than debt as a source of finance is also not in dispute. The difficulty with the contentions essentially is with their ‘solely’ and ‘only’ aspects. These aspects need a litmus test to find

whether Mirakor's thesis has legs to stand on or is likely to collapse under its own weight. This paper is a humble attempt in that direction.

To that end, Section 2 briefly explores the relationship between risk and return to capital. Section 3 examines the proposition that Islam allows *only* the sharing of risk as the basis of financing. Section 4 extends the critical appraisal of the risk-sharing rule in its exclusivist frame.

A number of empirical studies - the latest in the series being of Mirza et al (2015) - claim that Islamic banks have faced the current turmoil better than the conventional. The proponents of the precept cite these empirics as the evidence in support of their claim to the relative superiority of Islamic finance and its projection as a replacer for the conventional system. Section 5 scrutinizes this evidence. Finally, Section 6 concludes the argument of the paper with a few additional observations.

## **2. RISK AND RETURN TO CAPITAL**

The adage 'no risk, no gain' presumes an unbreakable linkage between risk and return to capital. Is this presumption valid? Historically, the association of risk with return on capital emerged to justify the charging of interest on loans largely taken to meet basic survival needs or to perform social rituals (Rubin, 2011: 1313). The flow of money was from the rich to the poor in society. The rates of interest were exploitative as most borrowings did not create the means for their own repayment. In default, the transfer of tangible assets from the poor to the rich was a common occurrence. The emergence of grinding poverty and abhorrent distributional inequalities of wealth and incomes were the consequence.

However, commercial lending grew rapidly with the passage of time and the bulk of the loans in Arabia were indeed for commercial purposes when Islam made its advent on the scene (Chapra, 1986, 64). But during the early decades of industrial expansion (1775-1825), men normally used their own capital in dominant industries, hiring labor and renting land and tools from others. The managerial function centered on the capitalist, and competition was moderate. Thus, Marshall in his *Principles of Economics* (1890) could see an industry dotted with tiny owner-operated firms, growing and falling on their own while the industry continues to grow just as trees do while the forest continues to grow. The analogy implied that the issue of profit appropriation was then of little consequence, with entrepreneurship and management forming a single entity.

During this early era of industry, the income of the owner-manager naturally got linked up with capital. In all the classical writings, the word 'profit' is found to be used in this sense (Ormerod, 2010). However, this association gave rise to much confusion in economic theory as interest also was attributed to the owners of capital. Early classical writers could not provide a basis to separate the two or justify their attribution to the same functionary, the capitalist (Knight, 1921: 23). Latter-day economists created the distinction between interest and profit by linking profit to risk (Hawley 1893), albeit they still saw an element of risk remaining associated with interest (Knight 1921). Importantly, however, Knight nullified all theories tying profit to risk. He did so

with a simple argument which briefly runs as follows. Under perfect competition where participants in production have, by assumption, complete information of the market and enjoy perfect mobility, economic profit must be zero; for normal profit that the firms get is treated as an element of cost.

The return to capital must be identical with the risk-free interest. Dynamic change that cannot be foreseen, however, makes competition imperfect, and business ventures become risky—money invested could shrink. This fear of losing money divides society into two sorts of people. Most people prefer to have assured incomes rather than face uncertainty. For, such assurance is available if they are willing to work for others. This is possible for, in fact, there are some others in society who are willing by temperament to derive their income by engaging in businesses in which they expect to earn higher incomes as profits. Accordingly, risk divides society into the hired and un-hired factors of production, the latter being the entrepreneurs who are risk takers and earn profit, and the former - the workers - who seek employment for secure fixed incomes. Thus came into being the residual claimant theory of profit (Hawley 1893).

Knight (1921) regarded the possession of capital as a necessary condition of entrepreneurship for in his view an empty-handed person could not guarantee contractual payments to the hired factors of production<sup>3</sup>. And yet, he did not see any connection between profit and capital. He considered profit to be a reward for entrepreneurial *services*. The proposition must be discomfoting for the ‘no risk, no gain’ proponents in Islamic finance. For, they do not regard the possession of capital as a pre-requisite for entrepreneurship. On the contrary, their *mudarib* is an empty handed worker. However, more damaging to the ‘no risk, no gain’ proposition is Knight’s treatment of risk in his work.

He divides risk in two parts – measureable risks and un-measureable risks which he labels respectively as ‘risk proper’ and *uncertainty*, the division difficult though (NYU.edu 2014). Measurable risks can be insured at a cost; thus they pose no threat to business and being cost, cannot be a part of profit. The premium paid to the insurer is a charge against revenues like wages or rent the businesses pay. It is uncertainty the un-measurable risk that forces one to peep into the future but what he could see would depend purely on luck or chance. The bifurcation is of far reaching consequence for Islamic finance where *gharar* or uncertainty has to be avoided. The injunction implies reference only to uncertainty that can be measured i.e. to ‘risk proper’ as defined above.

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<sup>3</sup> Possession of capital being a necessary condition for entrepreneurship in Knight raises the question: Is it really the mental attitude to risk taking or lack of means to face uncertainty that plays the dominant role in dividing people into the hired and un-hired production factors? To me the question looks more as belonging to income and wealth distribution than a matter of temperamental differences.

Unless one is able to refute the logic of the uncertainty bifurcation, risk-management discussions in modern finance – Islamic or conventional – must lose much in content and significance. For, measureable risk must be insured; the un-measurable one or uncertainty we have no means to guard against. Beyond what can be insured at a cost, *tawakal* – welcoming what Allah may grant, profit or loss – is alone the best risk management tool for Islamic finance. Indeed, the present day risk management does not as it cannot measure total risk due to an un-measurable mix. Risk managers' measure probable (insurable) loss and to avoid it incur an internal cost possibly higher than the insurance premium<sup>4</sup>

Also, the risk-profit linkage we referred to above cannot be shown delivering justice, one of the top priorities of Islamic finance; for, no one-on-one correspondence can be established between risk and profit because of uncertainty affecting both. Furthermore, risk-profit linkage is but *ex ante* whereas the negotiated sharing applies to a division of *ex post* profit; no risk is involved. Islam allows sharing of profit (loss) of which risk sharing is a consequence, not the cause.

The contribution of Knight contextual to Islamic finance is twofold. First, he provides a precise definition of what risk is and what it is not. In contrast, the proponents of basing Islamic finance solely on risk-sharing never clarified what they meant by risk or what distinction they make between risk-sharing and risk transfer? And, in what situation one of the two would hold well against the other? Is sharing or transfer of risk to be within the capitalist class or other factors in production should also be participating in sharing? It is such sort of issues that we shall address in the following sections.

Second, Knight took note of the rise to dominance of modern corporations that has characteristically changed the risk-profit equation in businesses; especially finance. Capital, organization and entrepreneurship have become distinctly separate entities with reference to their rewards. The bond between profit and risk-taking has much loosened. The appropriation of profit has long become non-functional, not governed by any theory, power is the arbiter. The proponents of risk-sharing do not seem to have imbibed the ramifications of this change and its impact on risk-reward equation.

### **3. RISK-SHARING AND ISLAMIC FINANCE**

The claim 'no risk, no gain' is based on a rather restrictive interpretation of a leading Islamic maxim derived from a Prophetic tradition; it says: 'Benefit goes with liability'<sup>5</sup> The problem is with the interpretation of the word 'liability' in the expression as the bearing of risk in financial

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<sup>4</sup> There is a fundamental difference between the reward for taking a known risk and that for assuming a risk whose value itself is not known. Risk managers can measure only the mathematical probability of loss – the *known* risk but a known risk will not lead to any reward or special payment at all (Knight 1.11.38).

<sup>5</sup> For a detailed discussion on the maxim see Professor Laldin (2013, 156-160)

transactions<sup>6</sup>. Islam allows profit and loss sharing contracts among financing modes but not to the exclusion of others considered equally valid. Risk bearing is a consequence - not the cause - of such contracts. To put it straight, there is no such thing in Islam as a risk sharing contract which when entered into would result in the sharing of profit or loss. Liability in the maxim focuses on compensation, not on risk; for risk is not a tradable commodity in financing. Risk-taking per se cannot contribute to production; ownership of useful things including capital does. Equity of a profit share can be better judged with reference to capital investment not with reference to risk.

The contention finds support from another Islamic maxim, an inverse of that under discussion. It is derived from the Qur'an (2:275) and says: 'Liability accompanies gain'. There has to be a compensation for receiving a gain. Thus, for a claim to profit, financier is liable to bear ex post loss, not the ex ante risk (Baqir as-Sadr 1984).

Conventional finance is of course dominated by interest based transactions, but it is far from truth that it entails no risk-sharing. Equity holders share risk and equity dominates in long-term financing. Even when loans are advanced on interest bank face the risk of default and of adverse price movements in collaterals. That banks collapsed like card houses in the current turmoil is evidence enough to see that interest-based finance is not always or entirely risk-free. Likewise, Islamic banks do transfer risk via hedging contracts. They also take collaterals to cover default risks. Bulk of transactions Shari'ah supervisors approve is debt based; participatory finance despite all effort and pleadings is still not popular. The valid distinction between Islamic and conventional finance is not that one is entirely risk-sharing and the other is entirely risk-transferring; in either case, what matters is their proportion in the mix<sup>7</sup>.

Furthermore, it is not true that Islam bans risk transfer. It is a matter of interpretation. Banning interest does not imply an automatic ban on risk-transfer. Indeed, there is an argument that in pure classical *mudarabah* where the worker/entrepreneur is empty-handed the financier transfers a part of his risk to the worker. The financier does not make any payment to him in case of loss. He reduces his own loss equal to the transfer earnings of the worker; in a way risk is in part passed on to him (El-Gamal 2014, 1). Likewise, risk-sharing need not always be equitable, may be, it is rarely so. Risk being ex ante has no cardinal measure. The sharing ratio is a crude proxy for the division of profit. No one can demonstrate a one-on-one correspondence between the profit share of the parties and their respective risk exposures. Justice and fair play is the first

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<sup>6</sup> Presumably, putting the maxim as 'benefit goes with liability (to compensate)' – would be more explicable of its intent and import. It would also commensurate well with another Islamic maxim – legal permission negates liability. Candidly, the liability to bear loss in business cannot be abolished; it would go against the Islamic ban on interest. For details on the quoted maxim, see Professor Laldin (2013, 164-166).

<sup>7</sup>It is interesting to note that some writers find Islamic finance inherently more risk-averse and thus holding the pace of economic development in Muslim countries; they produce evidence. In contrast, those who argue that it is in principle based on risk-sharing have nothing to show as testimony.

requirement for calling something ‘Islamic’. The difficulty is that tons of juristic writings analyzing contract forms provide little help to determine whether or not there is injustice in the exchange contract. Arbitrariness is the rule<sup>8</sup>.

The present resurgence of risk-sharing is no more than the echo of the ‘no-risk-no-gain’ adage which is ingrained since long in the literature as the sole principle for organizing Islamic finance as noted earlier. The present author had a detailed discussion on the precept much earlier (Hasan, 2005, 16-18). Interestingly, the reiteration of the precept under review tends to rely essentially on evidence extracted from the mainstream sources rather than from earlier Islamic finance literature. The mainstream writings in economics are growing fast and the literature is so vast that evidence can often be marshaled on either side in a debate, including risk-sharing, with impressive documentation.<sup>9</sup> Important, however, is to examine the logic behind theoretical propositions.

At times the proponents of risk sharing switch over from a narrower argument to the cosmopolitan plane in their explorations without notice and without forging a link with their narrower business oriented discussions (Askari et al 2012). They unwittingly voice the concerns of market capitalism in restricting their focus to the risk of losing money and material while the risk that human beings face working in various sorts of production lines are ignored even as such risks could be and usually are more persistent and fatal to limbs and life compared to the loss of money in business.

Men, women and children working in coal mines, glass blowing, cement factories, cotton ginning, on oil-platforms in open seas, on nuclear reactors or even controlling traffic at the crowded road crossings face hazards no amount of money can compensate. During cyclical ups

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<sup>8</sup> Contextual to n.4, the profit which the owner of a commodity obtains through its sale is based not on the risk involved but on the basis of the commodity proprietorship, even if the price (and profit) increases due to his transferring it to the market for ready availability to the consumers for he continues to remain its owner (Baqir-as-Sadr 1984, 76).

<sup>9</sup> The classification of the notes and references in one such study in the references confirms the generous borrowings from the mainstream sources; some even from the heterodox literature. The bibliography contains 325 entries. Only 75 of these are from Islamic writers. Of the 75 no less than 40 belong to the writers of the book itself. Thus, for the criticism of the mainstream positions too our scholarship essentially draws on the mainstream!

<sup>10</sup> Robert B. Reich (2015) who has served in three national administrations in the US, paints a dismal picture of the workers’ condition in the country, the largest economy of the world. He writes “As Labor Day looms, more Americans than ever don’t know how much they’ll be earning next week or even tomorrow. This varied group includes independent contractors, temporary workers, the self-employed, part-timers, freelancers, and free agents..... (all get) no predictable earnings or hours.... it’s happening at lightning speed. It’s estimated that in five years over 40 percent of the American labor force will have uncertain work; in a decade, most of us.”

Today (September 20, 2015) 25% of Greeks are unemployed. The suicidal deaths of the farmers to get rid of poverty are causing disquiet. Conditions in most Muslim countries are no better. These facts stare hard in the face of our risk-sharing ivory tower proponents



and downs who suffer more – capital or workers -depends on the terms of contracts that govern their employment<sup>10</sup>. If there is a case for risk (and profit) sharing among the providers of capital, there is one, million times stronger, for such sharing between labor and capital, especially from Islamic viewpoint (Hasan, 1975 and 1983).

A further assertion of the ‘no risk, no gain’ proponents that interest-based financing is entirely about risk transfer and therefore risk free for the lender—is again untenable. Conventional lenders do face risks of default regarding the principal and/or interest. Furthermore, the interest rate faces fluctuations via the bond market. If interest-based finance were entirely devoid of risk, could mighty financial institutions have collapsed as they did in the current turmoil? Furthermore, is there any worthwhile estimate as to how much risk conventional institutions transfer to others? What capital faces in deferred payment Islamic contracts is not much different from the conventional risks, and mortgages provide cover in both cases. If there is a difference between equity and debt with reference to risk, it is of degree, not of kind. Interestingly, sharing of risk may involve its transfer. There could be cases, as in sleeping *muḍārabah*, where one can legitimately see risk transfer in risk sharing.

Finally, another distinction the proponents make relates to the fixity versus variation of payments with regard to interest and profit. It is argued that fixed return to capital is not allowed in Islam; even its use as a benchmark is questionable in some forums. However, this is only partially true. Islam does allow a time value to money as part of the price in deferred payment contracts based on *murābahah* (cost plus) - an agreed fixed margin financing mode). Deferred payment sales involving mark-ups are debt-based transactions. We are not aware of any juridical preference between contracts involving profit sharing on the one hand and those stipulating predetermined returns on the other if both meet the stipulated Sharī‘ah requirements.

#### 4. SOME MORE COMMENTS

Knight (1921) was categorical that profit is not a return to capital; it is a reward for entrepreneurial services—primarily relating to direction and coordination of the business. But by the time he was writing the preface to the fourth edition of his *Risk, Uncertainty and Profit* in 1957, the corporate form of business organization had risen to dominance, the personality of the classical entrepreneur, as alluded to earlier, had disintegrated, decision making had become scattered throughout the managerial hierarchy<sup>11</sup> and competition had become increasingly intense. What remained intact of Knight’s work was the distinction between risk and uncertainty and its implications for economic theory and practice. The distinction shows that risk taking cannot be planned to produce desired results. It could be a personality trait but cannot be measured, and no economic value can be put on it. Thus, risk is a specific mental state that

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<sup>11</sup> If there was little agreement on the identification of the entrepreneur in a modern corporation, there was even less on the functions he performed. The concept has melted down into a heuristic analytical tool with little real content. Knight’s uncertainty theory was reduced to a windfall profit/loss case of little significance as probability based instruments cannot predict or measure them (Hasan, 1975, 1983).

instills in a person the fear of adverse consequences of an action; for example, the fear of losing his capital as an investor. Two options are open to such a person; for example, the capital owner

- (i) He is free to desist from the action if he cannot overcome the fear of adversity, i.e. of losing money; no one would penalize him if he does; or,
- (ii) He must conquer his fear and act and accept whatever be the consequence. Risk-taking is purely discretionary for humans. For that reason Islam neither promises a reward to a risk-taker nor refuses a reward unless risk is taken. Consider the following examples as evidence:

Consider the following examples as evidence:

1. *Risk free earnings*: One can earn a profit in spot transactions without facing any risk. The post-price risk one takes is out of one's own sweet will; it does not arise in the course of the spot sale and purchase transaction. Pecuniary gains arise, devoid of risk, in the form of wages or rent for contributing to the permitted productive effort.
2. *Abolition of interest*: One justification capitalism advances for charging interest is the element of risk involved in lending. Thus, the lender has a right to compensation in the form of interest. No Islamic economist can deny that loans carry risk; why does then Islam bans interest? Simply for the reason that interest is not the result of any productive exertion undertaken by the lender to earn it.
3. *Ban on gambling*: Like interest, Islam prohibits gambling and earnings based on it, albeit gamblers take great risks and are even ruined at times. The reason again is that labor in gambling is unproductive of real goods. The ban on gambling also extends to the sharing of a pool of individual earnings. To illustrate, the Shaṛāḥ would not allow two doctors entering into partnership to take patients separately but pool their earnings to be shared in a pre-agreed ratio. This is to avoid the risk of anyone of the two not getting the just reward for his work due to the possibility of a plus or minus element brought in by the sharing of risk. (Baqir-as-Sadr 1984, 78).
4. *Tools of production*: The tools of production are not allowed to have a share in the profits of a venture even though they too are exposed to risk in the production process. But tool owners are not denied a return; they gain in the form of fixed returns (rentals). However, the Hanafiis do allow the tools as part of capital contribution provided their monetary value is agreed upon at the start of production.
5. Some other earnings involving risk are disallowed: certain sources of income (gain) like magic, witchcraft, fortune-telling or jugglery are not allowed in Islam even if risk is involved because they do not contribute to socially useful production

All these and the like are ways of illegitimately consuming one another's wealth as no trade with mutual consent is involved (Qur'ān, 2:188; 4:129). Even though risk may be involved, gain/profit may not be legal. The permissible way of generating profit and its sharing is allowed in all cases where participants can be shown as contributing to socially useful production.

Consequently Baqir-as-Sadr (1984: 76) laments as follows:

*Many have fallen into error influenced by capitalist thought which has a tendency to explain the point and its defense on the basis of risk. They say or have said that the profit*

*allowed to the owner of the stock-in-trade (cash capital or commodity) in the muḍārabah contract is theoretically based on risk because even though the owner of the stock-in-trade does not do any work yet he bears the burden of the risk and exposes himself to loss over his cash or commodity to the agent trafficking with it; so it is the duty of the agent to make proportionate percentage of compensation against the ventured risk out of the profit agreed upon in the muḍārabah contract between them.*

*But the fact has been made fully clear in the previous discussion that the profit which the owner of the cash or commodity obtains as a result of the agent's trafficking of it is not based on the risk but receives its justification on the basis of proprietorship of the owner of the cash or commodity with which the agent traffics.*

If one wants to make risk sharing the fulcrum of Islamic finance to the exclusion of other permissible modes of financing, one must take an extended view of risk and show its applicability in various socioeconomic conditions as harmonizing with the Islamic norms of justice. An attempt to do so has to be comprehensive and complete to avoid raising insoluble problems. This would be a palpably horrendous task not worth the effort.

We find the risk-reward equation grossly misleading. The profit which the owner of a commodity obtains through its sale is based not on the risk he takes but on the basis of the commodity proprietorship, even if the price increases due to his transfer of the commodity to the market for ready availability to the consumers, for he continues to remain its owner (al-Sadr, 1984: 75-76).

## **5. CURRENT FINANCIAL CRISIS AND ISLAMIC BANKS**

Let us have a look at the claim that Islamic banks have faced the crisis better than the conventional testifying to the inherent strength and resilience of the system. This strength follows it is argued from a close link between financial flows and productivity in the real sector of the economy. Nabi (2012) finds that the presence of diversification in Islamic banking sector across countries reduces the vulnerability of financial contagion. Ahmed (2010) confirms: "This intrinsic property of Islamic finance contributes towards insulating it from the potential risks resulting from excess leverage and speculative financial activities which are part of the root causes of the current financial crisis". Many others including Abbas (2007) and Chapra (2014) have followed the line. The factors mentioned in these writings may have possibly kept Islamic banks less affected during the crisis but at the same time we cannot ignore certain other factors that may have softened the impact of crisis on them. Consider for example the following points.

- 1) Islamic banks are still too small to attract the contagion because of their tiny existence; the ratio of Islamic banks asset to the conventional was just 1:118 in 2011 even as it has been improving over the years.<sup>10</sup> It has again climbed down to 1:112 in June 2014
- 2) Islamic banks have not yet developed enough connectivity with the mainstream system for the transmission of the contagion. Even then, it is not true that Islamic banks have not at all

Islamic banks have not yet developed enough connectivity with the mainstream system for the transmission of the contagion. Even then, it is not true that Islamic banks have not at all been affected. It is on record that several banks of the UAE landed in trouble and the state had to bail them out.

- 3) Most comparisons employ econometric models where sample designs are dubious, reliability of data as also their homogeneity over time and space wear serious question marks. In particular, the contagion within the banking system is a smaller matter than the overall impact of the turmoil on the totality of the economic phenomena. The injury to banks is not the result of financial markets' chaos; it is just its reflection. The damage is the consequence of wide and wild lurching of the broad macroeconomic variables – national income, savings, investment, money supply, taxation, wage levels and so on.

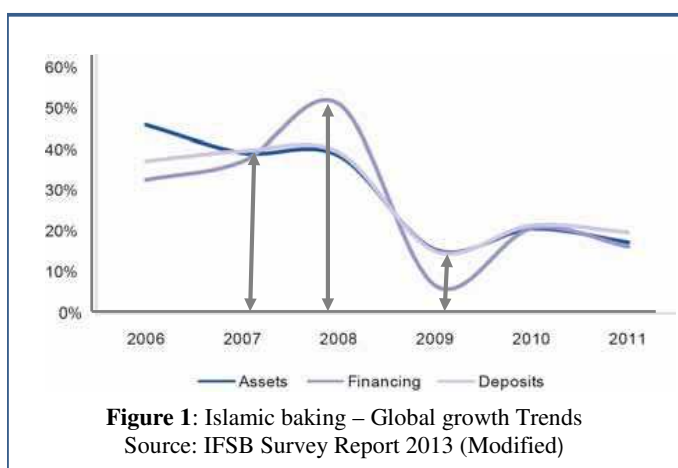


Figure 1 is revealing on the point Notice that round 2007, the assets, financing and deposits of Islamic banks were in harmony. Notice that around 2007, the assets, financing and deposits of Islamic banks were in harmony The movement towards 2008 saw an expansion in the excess of deposits over financing, a situation that reversed in 2009 but as part of an overall downward drift of all variables. A few individual banks in the Middle East did come to grief and in Kuwait banks in trouble were denied bailout. The evidence detracts much from the claim of Islamic banks coming out of the crisis unscathed.

## 6. CONCLUDING REMARKS

This paper aimed at examining the logic and tenability of an old precept whose revival in Islamic finance is recently being sought vociferously. The precept is claimed to mean that Islam permits no gain unless risk is involved in its earning. It is further argued that risk-sharing alone is commensurate with Islamic norms of financing. The supporters of the view blame the increasing recurrence of financial crises on interest-based finance because it promotes, they say, only the

transfer of risks, not their sharing. They assert that Islam bans interest and allows only the sharing of risks in financing, not their transfer. This critique has highlighted the unacceptability of this line of argument on both the juridical and feasibility fronts.

Contextually, the paper explains that the three Islamic maxims – benefit goes with liability, liability accompanies gain and deferment constitutes a part in price – read together lead us to only one conclusion that the right to receive any permissible benefit carries in Islam a counter liability to compensate the benefactor unless there is a legal waiver. The law remains neutral towards the exogenous consequences of meeting such liability, be it the risk to money, limb or life.

One must also note that interest-based financing is not altogether devoid of risk nor are all transactions in Islamic finance need be based on risk-sharing in the same way as it is shared in the case of equity. It is interesting that the Kuala Lumpur Declaration of October 1, 2012 on risk-sharing as an alternative to interest-based finance by-passed the proposal to say only this much: *“Governments should endeavor to move away from interest-based systems towards enhancing risk sharing systems by leveling the playing field between equity and debt.”*

The paper establishes that the ‘no risk, no gain’ precept cannot be defended as an exclusive principle of Islamic finance. Risk is not a tradable commodity; nor is it an act in itself contributing to the value of output. Many transactions involving risk are not allowed while many transactions not involving it are. The principle of sharing of profit and loss is valid, but its basis is not the existence or absence of risk.

In evaluating a situation and its causes, the moral and ethical dimension invariably escapes our attention. Principles of economics are essentially principles of economic policy, and no policy is worth more than what it is in execution. An Islamic Development Bank (IDB) publication aptly says:

*At its heart, Islamic finance is a moral system of finance. It emphasizes the balance between for-profit activities, or the market, and not-for-profit activities, including social and philanthropic activities. No economy can enjoy sustainable prosperity without the two domains in healthy equilibrium. Just as a bird cannot fly smoothly without the two wings properly functioning in tandem, an economy cannot “fly” without the two domains properly operating and serving the common good of the society (Suwailem, 2014).*

Most of the writings in the area of Islamic economics and finance are oblivious to the fact that the moral wing of the bird today is utterly non-functional, if not broken. They present their postulates on the tacit assumption that people are reasonably committed to moral and ethical norms, which is unfortunately not the case. When confronted with the choice of reaping

economic benefits or obeying religious imperatives, worldly concerns tend to outweigh the Hereafter consideration.

The proponents of making risk sharing the sole basis of Islamic finance should re-evaluate the Shari'ah basis of their argument. They should as well evaluate the feasibility of their suggestions. It may be noted that risk taking is not the same thing as risk sharing or risk transfer; it is fuzzy as to what variables could capture each of these expressions for the model remaining free of internal inconstancies. In any case, such models cannot deal with the totality of risk that banks face; they only deal with its measurable truncated part. And, where variables are socked with morality norms, the use of non-parametric methods seems to have an edge over the probability-based explorations now so fashionable in Islamic finance research.

Last but not the least, this paper is neither opposed to risk sharing nor does it seek to mitigate the need for risk management. It is just a humble attempt to correct the perilous tilt to the Islamic finance growth trajectory, the proponents of 'no risk, no gain' dictum, in my opinion, are unwittingly insisting to impart.

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